Do Golden Parachutes Increase Shareholders’ Wealth in the M&A between ICT Companies?*

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**ABSTRACT**

In this paper, using game model, we show that the network effects from M&A in ICT sector can generate abnormal returns in the market. It is also shown how the antitakeover behaviors of target managers with golden parachutes can increase the shareholder wealth as well as the size of network effects. This is because the bidding strategies of acquiring firms depend on the target managers’ defensive strategies. Therefore, using golden parachutes, shareholders can increase the bidding prices and defeat the acquiring firm’s takeover attempt which generates lower network effects. The result shows that the probability of a successful takeover increases with GP. This paper also shows why most of the benefits of a successful takeover go to the target firm.

Key words: M&A, Network effects, Golden parachutes, ICT

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I . INTRODUCTION

In the wake of the post dot.com bust, many experts of the ICT sector have argued that ICT industry is entering a more mature phase through mergers and acquisitions (hereafter M&A). As a matter of fact, the number of M&A among ICT companies has skyrocketed since late 1990s. Especially, in the era of digital convergence and ubiquity, advanced internet technologies integrate the computer, communication, broadcasting and other electronic gadgets. Under these circumstances, in order to meet consumers’ new demands, M&A has become vital to ICT companies. (Chang 2004; Lee et al. 2008; Kim et al. 2010; Haeussler et al. 2012)

This paper argues that M&A in the ICT sector should lead to greater wealth creation because of the network effects. Koh et al. (1991) concludes that markets react favorably to the announcements of M&A in the ICT sector. Results from Das et al. (1998) indicate that ICT based M&A lead to higher abnormal profits than non-ICT -based M&A. From these results, markets seem to react more favorable to the combinations of ICT companies.

This paper distinguishes itself from the other previous researches, regarding M&A and network effects in the ICT sector. About the network effects and M&A, there is relatively much more research that used empirical studies rather than theoretical backgrounds (Leger et al. 2003; Faulhaber 2001; Baum et al. 2000; Dyer et al. 2000). This paper attempts to provide theoretical explanations of M&A in the ICT sector by using a game model and further tackles the issue of premium sharing by using the network effects.

Regarding the premium sharing in M&A, we put forward the hypothesis that golden parachutes (hereafter GP) should influence the bidder to make appropriate

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1. In case of portal sites, the more consumers exist, the more information is freely exchanged. Consequently, consumers enjoy more benefits (direct effects), and companies strengthen their brand name and make cheaper complementary goods through the larger networks (indirect effects). Hence, ICT companies tend to attempt M&A more frequently than others in order to generate larger network effects. In this paper, network effects include both the former and the latter effects. More details about network effects are available in Liebowitz & Margolis (2003).

2. Golden parachutes are contracts between target management and shareholders promising some compensation to the managers when they have to leave the firm after it is successfully acquired. Here, we consider a contract which pays some portion of takeover premium in the event that a change of control occurs. One example is through stock options which result in some payoffs to the target manager because of a higher stock price after successful M&A. For a more detailed explanation of GP, see Quintero (1989).
bidding decisions to ensure the emergence of network effects in the new entity.

There are two competing hypotheses concerning the motivation for GP adoption and their associated effects on shareholder wealth. The first hypothesis is that GP help to resolve the conflict of interest between shareholders and managers and create more favorable conditions for managers to accept takeover attempts (Heitzman 2011; Cai & Vijh 2007; Fich et al. 2011). The second hypothesis is that GP are adopted only to transfer wealth from shareholders to managers (Lambert & Larcker 1985). This paper answers to the question of why shareholders are willing to provide GP to managers who exercise antitakeover techniques.

We develop a model of the non-cooperative game with incomplete information. And we use perfect Bayesian equilibrium as a solution concept.

This paper produces two main results: Most of the benefits from positive market reaction in M&A go to the shareholders of a target firm. The higher returns generated by the M&A in the ICT sector can be explained through the network effects.

The result also shows that GP lead to higher premiums as well as larger network effects. GP can make the managers’ self-interested antitakeover techniques beneficial to the shareholders of target firm. The basic idea is that without an appropriate level of compensation, managers resist the takeover offers in order to retain their control which potentially harms shareholders. Hence, the shareholders of target firms are willing to compensate their managers appropriately so that they will not reject the takeover attempts. Another interesting feature of GP is that target managers can in certain cases defeat bids that are inadequate and promote the takeover premium by extracting a higher offer price from the bidder.

This paper obtains other results which are supported by empirical works. First, our model shows that the probability of a successful takeover attempts increases with GP. Second, it explains why most of the benefits of a successful takeover go to the shareholders of a target firm. Third, we show that some takeover attempts are destined to fail because of inadequate bidding prices.

This paper proceeds as follows. In section II, we discuss the issues using a five stage non-cooperative game model. We provide empirical evidences in Section III and conclude this paper in section IV.
II. M&A WITH GP AND NETOWRK EFFECTS

In this section, we present a model which allows us to illustrate the proposition that the behaviors, specifically the antitakeover techniques, of management can serve its shareholders’ interest with the manager level employment contracts, GP. Our model also presents the network effects as a main source of M&A premium.

There are three players, acquiring firm (AC), target manager (TM), and shareholders of target firm (SH). All players in the model are risk neutral and try to maximize their own payoffs. AC comes in two types, H or L, distinguished by the size of the network effects, \(A(s)\), that can be obtained through the takeover of the target firm.\(^3\)

The function indicating this network effect is the following:

\[
\text{[Assumption I]} \text{ If } s_i < s_j \text{ for given } i \neq j, \text{ then } \frac{A(s_i)}{s_i} < \frac{A(s_j)}{s_j}.
\]

SH does not know the exact type of AC, but it is common knowledge that H generates the network effects, \(A(2)\), and comes with the probability of \(p\) and L generates the network effects, \(2A(1)\), and comes with the probability of \((1-p)\), where \(0<p<1\).\(^4\) The target firm is acquired via a hostile tender offer.

Consider the following set up: Let \(t \in [0,1]\) be the level of SH’s resistance and \(r \in [0,1]\) be the level of TM’s resistance. Let \(b\) be the AC’s bidding price and always greater than or equal to the initial stock price of the target firm. Let \(\delta \in [0,1]\) represent GP\(^5\), the portion of takeover premium going to TM. The contract is that SH providers \(\delta\) portion of premium to TM when there is a successful takeover and change in management.

\(^3\) The sources of M&A gains can be synergy effects as in the case of consolidation of R&D labs, economies of scale, tax savings, or management improvement etc. In this paper, we focus on the network effects as a type of synergy gains. In order to do that, it is assumed that there are no other synergy gains than network effects, i.e., the size of other synergy gains from H’s takeover is equal to that of L’s takeover.

\(^4\) \(A(s)\) represents the size of network effects, where \(s\) is the network size. In order to simplify the model, we assume that \(A(2)/2\) generates larger network effects than \(A(1)\) does.

\(^5\) A natural way to resolve the conflict of interest between the manager and shareholders is to give the manager a contract that will make him act as if he were a target shareholder. This can be done by giving the manager a proportion, \(\delta\), of the premium captured by the target in the hostile tender offer. Berkovitch et al. (1990a) and Heitzman (2011) consider similar GP in their researches.
W is the TM’s total level of preference for control of the firm, \( i \) is the initial stock price, and \( b-i \) is the premium. With GP, \( \delta(b-i) \) goes to TM and \( (1-\delta)(b-i) \) goes to SH when a successful takeover occurs. The payoff for H is \( A(2)-b \) with a successful takeover and zero otherwise. The payoff for L is \( 2A(1)-b \) with a successful takeover. Otherwise, it is zero. The payoff for TM is zero with a successful takeover and no GP. It is \( \delta(b-i) \) with a successful takeover and GP. Otherwise, it is \( W \). The payoff for SH is \( b \) with a successful takeover and no GP. It is \( b-\delta(b-i) \) with a successful takeover and GP. Otherwise, it is \( i \).

We assume that target managers have a very small equity amount of the firm so that their payoffs from the shares of the takeover premium are trivial compared to the loss from losing control. In other words, the benefits of control are sufficiently large in relation to any capital losses by unsuccessful takeover attempts.

If the shareholders and managers of the target firm are indifferent, i.e., they have the same payoffs as before the takeover attempt, they do not reject the bids (they choose \( t=0, r=0 \), respectively). If the acquiring firm has the same payoffs as before, they attempt the takeover. This is all common knowledge.

Also, note that the takeover can not occur if managers or shareholders are fully against it (\( r=1 \) or \( t=1 \)). This is the case that TM has full control of voting rights or can totally eliminate takeover bids.\(^6\)

The model is a five stage game. In the first stage, SH decides the compensation scheme, GP, \( \delta \in [0,1] \). SH must ensure that the GP provide TM with an incentive to get the best possible bid for SH. They contract on the share, \( \delta \), of the future bidding premium which they will receive. In the second stage, nature decides the type of AC, then AC decides the bidding prices, \( b \in [i, 2A(1)] \) if it is L and \( b \in \)

\(^6\) There are many examples for this case. Managers can increase their control of voting rights through capital structure changes, corporate charter amendments, voting trusts, dual voting recapitalizations, or the acquisition of shareholder clientele. For example, corporate charters specify the governance rules for takeovers (such as the percentage of stockholders that must approve a takeover). Firms can amend their charters to make the conditions for shareholder approval of takeovers more stringent. These antitakeover amendments include super-majority provisions and provisions for the staggered election of board members.

Note that we assume managers do not control the voting rights by their equity ownership, i.e., they have very small equity amount of the firm. Therefore, shareholders here refer to the outside shareholders who hold the majority of the equity but have nothing to do with management. Stulz (1988) was able to explain similar results of management’s antitakeover behavior when management is a large shareholder. The other types of actions which can eliminate takeover bids include initiation of antitrust complaints, standstill agreements, poison pills, or premium repurchases of the target’s stock held by the bidder (green mail).
[i, A(2)] if it is H in the third stage. In the fourth stage, TM decides the levels of resistances, $r \in [0,1]$, and SH decides the levels of resistances, $t \in [0,1]$ in the last stage.

**Proposition 1**: When target managers have no defensive strategies, perfect Bayesian equilibrium can be characterized as follows: $\delta^* = 0, b^* = i$ regardless whether AC is H or L, $r^* = 0$, and $t^* = 0$ at any belief on the AC’s type.\(^7\)

**Proof**: Since TM has no defensive strategies ($r^* = 0$), SH have no incentive to provide GP ($\delta^* = 0$). Now this is like a two stage game where there are only two players, AC and SH. AC offers first and SH decide whether to accept it or not.

SH’s payoff is $i$ when there is no successful takeover and it is $b$ when there is a successful takeover. Therefore, SH have a dominant strategy to choose $t=0$, as long as $b \geq i$. Hence, the best strategy for any type of AC is to bid at the initial stock price. ($b^* = i$)

Therefore, any takeover attempt is successful. The equilibrium payoffs are (AC, TM, SH)=(A(2)-$i$, 0, $i$) when AC is H. When AC is L, the payoffs are (AC, TM, SH)=(2A(1)-$i$, 0, $i$).

**Proposition 2**: When target management has defensive strategies but no GP, perfect Bayesian equilibrium can be characterized as follows: $\delta^* = 0$, $b^*$ is any $b \in [i, A(2)]$ if AC is H and $b \in [i, 2A(1)]$ if he is L, $r^* = 1$, and $t^* = 0$ at any belief on AC’s type.

**Proof**: Since there is no compensation scheme, GP, it is a four stage game with three players, AC, TM, and SH. In the last stage, SH has a dominant strategy to choose $t^* = 0$, i.e., accept any offers. TM’s best response is to choose $r^* = 1$ against any offers from acquiring firms since a successful takeover will snatch TM’s previous payoffs, W. No takeover attempt can be successful regardless of the bidding price, $b^*$.

Q.E.D.

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\(^7\) Note that each player’s decision is optimal given the previous players’ equilibrium behaviors and their beliefs about the subsequent players’ equilibrium strategies. Also, those beliefs are consistent with the actual equilibrium strategies of the players.
The equilibrium payoffs are \((AC, TM, SH) = (0, W, i)\), regardless of AC’s type.

**Proposition 3:** When there are both defensive strategies and GP, SH chooses \(t^* = 0\) in the last stage.

**Proof:** The payoff for SH when there is a successful takeover is \(b^* - \delta^*(b^* - i)\). The payoff when there is no takeover is \(i\). Now \(b^* - \delta^*(b^* - i) - i = (b^* - i)(1 - \delta^*) \geq 0\), for all \(\delta^* \in [0,1]\) and \(i \leq b^*\). Therefore, \(b^* - \delta^*(b^* - i) \geq i\). In other words, SH wants to have a successful takeover regardless of the belief on AC’s type as long as the offering price is greater than or equal to the initial stock price. \(\text{Q.E.D.}\)

The shareholders have a dominant strategy, \(t=0\), for the bid greater than or equal to the initial stock price, i.e., there is no free-rider problem. The justification is that bidding firms can make a two-tier bid and front-end load in the offer. By the front-end loading the offer, the bidding firm provides an incentive for target shareholders to tender.\(^8\)

In the fourth stage, given \(\delta^*\) and knowing that \(t^* = 0\), TM chooses its best responses with the belief on AC’s type given \(b^*\) as follows:

\[
\begin{align*}
r^* = 1 & \text{ if } W > \delta^*(b^* - i), \text{ i.e., } b^* < (W / \delta^*) + i, \\
r^* = 0 & \text{ if } W \leq \delta^*(b^* - i), \text{ i.e., } b^* \geq (W / \delta^*) + i.
\end{align*}
\]

(1)

In the third stage, to make a successful takeover, AC should offer \(b^*\) which is greater than or equal to \((W / \delta^*) + i\). Let \(b\) be the minimum level of bidding price which can make a takeover successful, i.e., \(b = (W / \delta^*) + i\)

The acquiring firm chooses the price, \(b^*\), to maximize its own expected payoffs. Therefore, H’s best responses are to choose

\[
\begin{align*}
b^* = b & \text{ if } A(2) \geq b, \\
b^* = \text{any } b \text{ in } [i, A(2)] & \text{ if } A(2) \leq b
\end{align*}
\]

(2)

\(^8\) The two-tier bid and front-end load offer, which are commonly used by the bidder in hostile tender offers, justifies the SH’s dominant strategy. The two-tier bid and front-end load bid are when the offer price is greater than the price of any unpurchased shares. When the bid is front-end loaded, individual shareholders will have the incentive to tender to receive the higher front-end price.
Now L’s best responses are to choose
\[ b^* = b \] if \( 2A(1) \geq b \)
\[ b^* = \text{any } b \text{ in } [i, 2A(1)] \text{ if } 2A(1) \leq b \] (3)

In the first stage, considering the expected behaviors of subsequent stages, SH decides the optimal contract, \( \delta^* \).

**Proposition 4**: In the first stage, SH’s best responses are to choose
\[ \delta^* = W/(A(2)-i), \text{ if } p \geq (2A(1)-W-i)/(A(2)-W-i), \]
\[ \delta^* = W/(2A(1)-i), \text{ if } p < (2A(1)-W-i)/(A(2)-W-i). \]

**Proof**: The final payoffs for SH depend on the actions of TM and AC which, in turn, depends on the contract, \( \delta \). Since TM negotiates deals for SH (TM chooses \( r^* \) before SH chooses their resistance level), the latter must ensure that the contract gives TM the incentives to choose \( r^* = 0 \). To maximize the payoffs, SH provides \( \delta \) such that \( \delta(b^* - i) = W \) from (1), which is the minimum amount of compensation to make TM accept any takeover bids. Therefore,
\[ \delta = W/(b^* - i). \] (4)

Now considering AC’s behavior in (2) and (3), SH know that (4) becomes \( \delta = W/(b - i) \) with a successful bidding price. (4’)

Since the payoffs become \( (1-\delta)(b^* - i) + i = (1-\delta)(b - i) + i = (W/\delta) - W + i \) with a successful takeover, SH have an incentive to make \( \delta \) as small as possible.

SH’s expected payoffs are \( i \) if \( \delta^* < W/(A(2)-i) \), i.e., \( b > A(2) \) (no takeover is successful), and \( p(A(2)-W)+(1-p)i \), if \( W/(A(2)-i) < \delta^* \leq W/(2A(1)-i) \), i.e., \( 2A(1) < b \leq A(2) \) (only H’s takeover attempt is successful). If \( \delta^* < W/(2A(1)-i) \), i.e., \( b < 2A(1) \), SH’s expected payoffs are \( 2A(1)-W \) (both H and L can have a successful takeover).

There are only two candidates which can provide the maximum expected payoffs to SH: \( p(A(2)-W)+(1-p)i \) and \( 2A(1)-W \). If \( p(A(2)-W)+(1-p)i \geq 2A(1)-W \) i.e., \( p \geq (2A(1)-W-i)/(A(2)-W-i) \), then SH choose \( \delta^* = W/(A(2)-i) \) so \( b = A(2) \). If \( p < (2A(1)-W-i)/(A(2)-W-i) \), then SH choose \( \delta^* = W/(2A(1)-i) \) so \( b = 2A(1) \).

Q.E.D.
When there are antitakeover techniques of target management with GP, perfect Bayesian equilibrium can be characterized as follows:

If \( p \geq \frac{(2A(1)-W-i)}{(A(2)-W-i)} \), which becomes a separating equilibrium condition, and AC is H, then \( \delta^* = \frac{W}{(A(2)-i)} \), \( b^* = A(2) \), \( r^* = 0 \), \( t^* = 0 \), and the takeover attempt is successful. The equilibrium payoffs are \((AC, TM, SH) = (0, W, A(2)-W)\).

If \( p \geq \frac{(2A(1)-W-i)}{(A(2)-W-i)} \) and AC is L, then \( \delta^* = \frac{W}{(A(2)-i)} \), \( b^* \) is any in \([i, A(2)]\), \( r^* = 1 \), \( t^* = 0 \), and the takeover attempt is unsuccessful. The equilibrium payoffs are \((AC, TM, SH) = (0, W, i)\).

If \( p < \frac{(2A(1)-W-i)}{(A(2)-W-i)} \), which becomes a pooling equilibrium condition, and AC is H, then \( \delta^* = \frac{W}{(2A(1)-i)} \), \( b^* = 2A(1) \), \( r^* = 0 \), \( t^* = 0 \), and the takeover attempt is successful. The equilibrium payoffs are \((AC, TM, SH) = (0, W, 2A(1)-i-W)\).

If \( p < \frac{(2A(1)-W-i)}{(A(2)-W-i)} \), and AC is L, then \( \delta^* = \frac{W}{(2A(1)-i)} \), \( b^* = 2A(1) \), \( r^* = 0 \), \( t^* = 0 \), and the takeover attempt is successful. The equilibrium payoffs are \((AC, TM, SH) = (0, W, 2A(1)-i-W)\).

When the probability of meeting an AC with larger network effects is relatively high, shareholders provide a low compensation contract so that management rejects a bid from an AC with smaller network effects. When the probability is relatively low, shareholders will provide a high compensation contract so that management accepts a bid from any type of AC.

**Proposition 5:**

(i) When target managers have defensive strategies, the adoption of GP is associated with the higher probability of successful takeovers.

(ii) The antitakeover techniques of target managers with GP are associated with the higher wealth of shareholders.

**Proof:** (i) When target managers have the defensive strategies, the probability of a successful takeover is zero without GP. The probability of a successful takeover with GP is \( p \) under the separating equilibrium condition and it is 1 under the pooling equilibrium condition. (ii) SH’s payoff without GP is the initial stock price, \( i \). Also, without TM’s defensive strategies AC will offer only the minimum price, \( i \), just enough to make a successful takeover. On the other hand, SH’s payoff with TM’s antitakeover behavior and GP is \( b^* - \delta^*(b^* - i) \geq i \) from proposition 3.

Q.E.D.
This paper provides theoretical explanations of M&A among ICT firms by using network effects. It is shown that M&A between ICT firms generate network effects that should translate into the creation of wealth for the shareholders of target firms. In particular, network effects can be the reason why M&A in the ICT sector are more frequently observed and outperform the others.

When there are no defensive strategies for the target managers, acquiring firms attempt the takeover with unfair bids which provide no benefits to the target shareholders. When there are defensive strategies for the target management and if target management is unable to obtain GP, any offers from acquiring firms are of no use. However, when the managers are able to obtain the defensive strategies and the optimal GP, acquiring firms must make a fair bid to have a successful takeover. Then the managers’ wealth maximizing behavior causes the shareholders’ wealth to increase.

Specifically, under the separating equilibrium condition, the antitakeover behavior of target management with GP defeats the acquiring firm’s takeover attempt which generates lower network effects and promotes the takeover premium to the highest level. This is possible because the bidding strategies of acquiring firms depend on the target manager’s defensive strategies. Therefore, shareholders can increase the bidding price as well as the size of network effects by controlling the manager’s defense strategies through manipulating GP.\(^9\)

Our results also explain why there are only modest positive returns to the successful bidders. Specifically, under the separating equilibrium condition, it is necessary for the bidders to make their bids equal to the maximum gains which leave no extra gains for the bidders from the takeover. Then the question is why the bidders attempt takeovers. Even though there are no clear answers about this yet, one possibility is that the managers of the bidding firms have some incentives to increase their power regardless of their shareholders’ welfare.

Another interesting implication of our model is that not every takeover attempt is successful even though it comes with a higher bidding price than the original stock price. The target managers with GP reject it since they consider it an unfair price and it does not produce enough network effects.

\(^9\) This is like a screening or a simple adverse selection model, in which the uninformed player (SH) moves first, offering a contract to TM, then, the informed player (AC) chooses his action. Here we assume that shareholders do not have other less costly screening devices.
Ⅲ. EMPIRICAL EVIDENCES

Some of the empirical implications of our model are supported by existing works. The main argument of this article is that M&A in the ICT sector should create more wealth in the market because of the potential network effects. In particular, M&A among ICT companies are more frequently observed because network effects function as means of not only improving efficiency in technological mastery, brand reputation and customer relationship but also minimizing their weaknesses and strengthening their competitiveness (Chang 2004; Kim et al. 2010; Haeussler et al. 2012).

The controversial arguments about the defensive strategies against takeovers are shown by Jensen & Warner (1988). It shows some possibilities that the defensive strategies of target managers may promote the takeover premium. It has been shown that over 75% of target firms that take bidders to court are finally acquired at significantly higher premiums than contained in the initial bids.

Harris (1987) shows that of a sample of NYSE firms that had adopted antitakeover methods and were subsequently acquired by other NYSE firms, 70% had GP. Several firms which had adopted both antitakeover methods and GP are United Technologies, Kraft, Pillsbury, and Macmillan, etc.

Some empirical studies about GP are those of Heitzman (2011), Cai & Vijh (2007), Fich et al. (2011), Lambert & Larcker (1985), & Knoeber (1986). These results show that GP have favorable effects on the reaction of managers to takeover bids, and the adoption of GP is associated with positive excess returns in security markets.

Our results are consistent with previous articles on the issue that market reactions to M&A announcements are generally favorable for the target and, at best, engender only modest positive returns to the successful bidders (Fuller et al. 2002; Loughran et al. 1997). Some possible explanations for the results are that acquiring firms have faced increasing competition from other acquiring firms, changes in regulation, and the development of more sophisticated antitakeover devices.

Ⅳ. CONCLUSION

In this paper, we show that the network effects from M&A in the ICT sector can
generate some abnormal returns in the market. It is also shown how the defensive strategies of target managers with GP can benefit target shareholders. With a proper contract, GP, target managers’ own wealth maximization behavior also increases the wealth of shareholders as well as the size of network effects.

Furthermore, this paper provides theoretical explanations of the following empirical results; (a) the probability of a successful takeover increases with GP; (b) why most of the benefits of a successful takeover goes to the target; (c) why a firm’s value increases after it adopts GP; (d) why some takeover attempts fail.

Some interesting extensions of our paper are the following. First, our analysis ignores the incentive for managers to negotiate the GP contract. Since shareholders obtain most large gains from takeovers, management may bargain GP contracts with shareholders which will provide better payoffs than the original payoffs, W.

Second, we consider only one representative type of defensive strategy of target managers. Different types of defensive strategies may cause different results. For example, some defensive strategies like corporate charter amendments, capital structure changes, and voting trusts are usually established before the takeover announcement. Since the acquiring firms can observe those defensive strategies, they may be able to calculate more accurate takeover costs. Other defensive strategies like standstill agreements, green mail, and poison pills are usually established after the takeover announcement. Since the acquiring firms need to speculate on the defensive strategies and the costs of a takeover, acquiring firms may become hesitant until they are sure about significant network effects.

REFERENCES

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